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IN THE

Supreme Court of the United States

OCTOBER TERM, 1935.

No. 232.

BRONX BRASS FOUNDRY, INC.,

Appellant,

against

IRVING TRUST COMPANY, as Trustee in Bankruptcy of J. R. Palmenberg's Sons, Inc.,

Respondent.

BRIEF FOR RESPONDENT

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AARON ROSEN,
ARNOLD A. JAFFE,
of Counsel.

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APPEAL FROM THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND DISTRICT

BRIEF FOR RESPONDENT

Opinions Below

The District Court rendered no opinion. The opinion of the Circuit Court of Appeals for the Second Circuit is reported in 76 Fed. (2nd) 935, and is found on page 87 of the transcript of record.

Statutes Involved

Section 60 of the Bankruptcy Act provides:

A. A person shall be deemed to have given a preference if, being insolvent, he has, within four months before the filing of the petition, or after the filing of the petition and before the adjudication, procured or suffered a judgment to be entered against himself in favor of any person, or made a transfer of any of his property, and the effect of the enforcement of such judgment or transfer will be to enable any one of his creditors to obtain a greater percentage of his debt than any other of such creditors of the same class. Where the preference consists in a transfer, such period of four months shall not expire until four months after the date of the recording or registering of the transfer, if by law such recording or registering is required.

B. If a bankrupt shall have procured or suffered a judgment to be entered against him in favor of any person or have made a transfer of any of his property, and, if, at the time of the transfer, or of the entry of the judgment, or of the recording or registering of the transfer if by law recording or registering thereof is required, and being within four months before the filing of the petition in bankruptcy or after the filing thereof and before the adjudication, the bankrupt be insolvent and the judgment or transfer then operate as a preference, and the person receiving it or to be benefited thereby, or his agent acting therein, shall then have reasonable cause to believe that the enforcement of such judgment or transfer would effect a preference, it shall be voidable by the trustee and he may recover the property or its value from such person. And, for the purpose of such recovery, any court of bankruptcy, as hereinbefore defined, and any State court which would have had jurisdiction if bankruptcy had not intervened, shall have concurrent jurisdiction.

Statement of Facts

The trustee in bankruptcy sought to expunge the claim of Bronx Brass Foundry, Inc., on the ground that the creditor had received payments on account, amounting to $1,000, which had been paid and received in such manner as to constitute a voidable preference (R., p. 4).

The creditor filed an answer to this petition (R., p. 5) in which it admitted, by failure to deny, paragraph "3" of the trustee's petition, as follows:

> "3. That within four months prior to the date of the filing of the petition in bankruptcy herein, and while the bankrupt was insolvent and indebted to divers creditors of the same class upon unsecured indebtedness provable in bankruptcy, and while knowing that the bankrupt was insolvent, said bankrupt transferred and paid over to the said Bronx Brass Foundries, Inc., the sum of $1,000.00" (R., p. 4).

The answer denied all other material facts (R., p. 5). On these issues, the trustee and the appellant proceeded to trial.

The trustee proved the following facts:

Seven payments on account had been made to the appellant, by the bankrupt, totalling $1,000, within a period of four months from the bankruptcy (R., p. 7).

On April 1st, 1933, within the four months and shortly before the payments were made, the bankrupt's capital had a book value of $243,745.37, after including an item of "good will, patents and trademarks" as an asset to the extent of $400,000 (Trustee's Exhibit 4, R., p. 74).

This item of good will, etc., at one time represented patents and trade marks which no longer had any value (R., p. 24). Eliminating the "good will", the bankrupt was insolvent to the extent of $156,254.63 (R., p. 74).

The payments to the creditor were made in May and June, 1933, and bankruptcy occurred on June 18th. It was alleged in the trustee's petition, and not denied in the answer, that, at the time of the payments, the bankrupt was insolvent.

The appellant had reasonable cause to believe that the payments would effect a preference, as appears from the following facts:

In March, 1933, the bankrupt called a meeting of its creditors and requested an extension of time to pay its debts (R., p. 8). At that meeting, the appellant was represented by Mr. Goldstein, its attorney (R., p. 8). A statement was made by one of the other creditors that the concern was "bankrupt" (R., p. 9). Figures were submitted at that meeting (Trustee's Exhibit 3; R., p. 72) (introduced at R., p. 21) and shown to the people there and discussed (R., p. 16).

The statement was of March 1st, 1933, and showed total assets, including good will, of $539,734.74 (R., p. 72). Deducting the $400,000 of good will, the book assets were only $139,734.74, whereas the liabilities amounted to $285,357.88 (R., p. 73).

The creditors were told that the business could not continue unless there was a definite extension of time, and it was assumed that the company was insolvent as shown by the statement (R., p. 24).

With regard to an extension of time, the appellant's representative said that his clients had not dealt very long with the Palmenberg's Company and they felt that they were entitled to preference on that account, over the older creditors (R., p. 25). The word "preference" was used by the appellant's representative.

The Bronx Brass Foundry commenced suit on its claim on March 15th, 1933 (R., p. 27). An answer was interposed and the plaintiff made a motion for summary judgment (R., p. 27).

Then the payments on account commenced and as each payment was made, the motion for summary judgment was adjourned (R., p. 27). The checks (Trustee's Exhibit 1; R., p. 68) were the checks of the bankrupt, to the order of Maxwell H. Goldstein, the attorney for the Bronx Brass Foundry. They were dated respectively:

April 24, 1933	$250
May 1, 1933	$250
May 19, 1933	$100
May 26, 1933	$100
June 9, 1933	$100
June 16, 1933	$100

There was another check for $100 which was not produced, but conceded (R., p. 7).

Two days after the last check was given, petition in bankruptcy was filed against the bankrupt.

After the trustee had proved all of the foregoing facts, the Bronx Brass Foundry sought to withdraw its claim (R., p. 59) and it filed a document which was called "notice withdrawing claim" (R., p. 6). Counsel for the creditor stated "We make no claim now in this proceeding against the J. R. Palmenberg's Sons, Inc. In other words, it is in the nature of a discontinuance" (R., p. 60). Upon the objection of the trustee, the referee held that the trustee might continue with proof on his objection to the claim, despite the attempted withdrawal (R., p. 61).

Thereupon, the attorney for the creditor withdrew and took no further part in the proceedings (R., p. 61).

Thereafter, the only testimony given was that of a certified public accountant, Matthew Jacobs (R., p. 62) who testified as to the assets and liabilities on April 1st, 1933, which testimony had already been covered in a general way by previous witnesses.

The referee found in favor of the trustee and ordered that the claim should be expunged unless the creditor sur-

render the preferential payment in the sum of $1,000 (R., p. 66).

That determination has been affirmed by the Circuit Court of Appeals and the matter comes before this court on certiorari.

Summary of Argument

A.

Respondent contends that the creditor had no absolute right to withdraw his proof of debt.

The proceeding to expunge the claim was instituted by the trustee and, in that proceeding, the trustee was the aggressor, seeking adjudication that a voidable preference had been received. The trustee should not be deprived of its right to such adjudication by the withdrawal of the defendant party. After the trustee had presented testimony practically proving its entire case, the estate should not be subjected to the delay and expense of re-litigating the issues. The trustee, as a representative of the creditors, would be prejudiced by any such delay or expense.

B.

The preferential effect of a partial payment must be determined by the actual distribution in bankruptcy, and not by some imaginary distribution at the time of payment.

One main purpose of the Bankruptcy Act is to insure equality among creditors of the same class in the actual distribution of the assets as of the date of bankruptcy. Payments on account are to be judged according to their effect on this actual distribution and not according to some imaginary distribution at the time of payment.

Argument

A.

The denial of the application to withdraw the proof of claim is not erroneous. In bankruptcy matters, delay and duplication of work and expense are prejudicial.

The creditor did not seek to withdraw its proof of claim until the trustee had introduced almost all of its evidence. Before the motion to withdraw was made, the trustee had proved the following material facts:

1. Payments aggregating $1,000 made by the bankrupt to the creditor (R., p. 7).
2. Knowledge on the part of the creditor of the bankrupt's failing condition, prior to the payments (R., pp. 8-22).
3. Circumstances surrounding the payments, showing intent to prefer, and the creditor's knowledge thereof (R., pp. 25, 38-42).
4. Insolvency of the bankrupt at the time of payments (R., p. 24),

This proof practically completed the trustee's case. After the withdrawal, the trustee called only one witness, a certified public accountant (R., p. 62) who testified in more detail concerning the financial condition of the bankrupt at or about the time of the payments in order to establish its insolvency.

The trustee had initiated this proceeding by a petition to expunge the claim (R., p. 4) on the ground that a voidable preference had been received. The creditor answered that petition (R., p. 5) denying certain allegations and admitting others by failure to deny.

On these issues, the trustee had the burden of proof and came into court *qua* plaintiff. It asked relief from the court in two respects:

First, an adjudication or finding that a voidable preference had been received. Second, a decree expunging the claim unless the preference was surrendered.

The creditor defended itself against this attack and came into court *qua* defendant.

It has been assumed that the creditor in this proceeding occupied the status of plaintiff and that the trustee occupied the position of defendant. Such a position of the parties might well have prevailed at the time of the filing of the proof of claim and before its proof or allowance. Once the claim had been proved or allowed, the status of the creditor was fixed until and unless some attack was made on that claim by the trustee.

Whitney v. *Dresser,* 200 U. S. 535.

After the trustee has commenced the proceeding to expunge the claim and has petitioned the court for affirmative relief by way of a decree as to the voidable preference, it is too late for the creditor to avoid such a decree by the voluntary withdrawal of the claim. To do so would be equivalent to permitting a defendant to discontinue an action which has been brought against him.

But even if we regard the creditor as plaintiff and the trustee as defendant, nevertheless, the creditor has no absolute right to discontinue, but its right to do so, whether at law or in equity, is subject to the limitation that the discontinuance shall cause no legal prejudice to the other party.

This court has held that in an action at law, the defendant may not oppose discontinuance solely on the

plea that he will be subjected to the annoyance of further litigation on the same claim.

Ex parte Skinner & Eddy, 265 U. S. 86.

The proceeding now under review is not an action at law, but arose in bankruptcy and is equitable in nature. The hearing had progressed to a point where the trustee might have rested and demanded a decree in its favor. Its right to receive such a decree is a substantial right and a discontinuance would deprive it of that right and would constitute serious legal prejudice.

It is true that some courts have extended the rule of *Ex parte Skinner & Eddy* to bankruptcy proceedings.

Scholl Mfg. Co. v. *Rodgers,* 51 Fed. (2nd) 971, C. C. A. 8;
Deeley v. *Cincinnati,* 23 Fed. (2nd) 920, C. C. A. 6.

In doing so, however, we believe that these courts have failed to draw the vital distinction between the proceeding in bankruptcy and other actions at law or in equity.

The trustee in bankruptcy, representing as it does, the interest of all the creditors in the administration of the estate, occupies a different position from that of the ordinary litigant. The trustee is charged with the duty of administering the estate for the benefit of creditors as expeditiously as possible to the end that the assets which have been sequestered by the court may be released to the equitable owners thereof, namely, the creditors, and without unnecessary delay.

After the claimant compels the trustee to go to the expense of procuring and producing evidence, the claimant should not be permitted to render that effort abortive and the expense fruitless by a voluntary withdrawal of its claim before the issues can be decided. Such tactics

on the part of the claimant react to the prejudice of the bankrupt estate and its creditors.

Delay for many months may be incurred if the trustee is now compelled to institute a plenary suit and to relitigate the issue of the voidable preference. If the decree of the Bankruptcy Court remains in effect, there has been a binding adjudication on all the material issues, and while a plenary suit would have to be instituted to recover the preferential payments, the creditor could interpose no valid defense and judgment in that action would be granted in summary fashion without delay.

At a time when we are all striving to minimize the delays and expense of litigation, particularly with reference to insolvent and bankrupt enterprises, it would be strange to hold that in bankruptcy matters the delay and expense involved in a relitigation of issues is not legally prejudicial to the trustee and the other creditors.

B.

The preferential effect of a partial payment must be determined by the actual distribution in bankruptcy, and not by some imaginary distribution at the time of payment.

The court is asked by the appellant to construe Section 60 B so as to have it read:

> If a bankrupt shall have * * * made a transfer of any of his property, and if, at the time of transfer, * * * and being within four months before the filing of the petition in bankruptcy * * * the bankrupt be insolvent and the * * * transfer then operate as a preference (so that its effect will be to enable the person receiving it to obtain a greater percentage of his debt than any other creditors of the same class could have received if the assets were then distributed) and etc. it shall be voidable by the trustee, etc.

There is nothing in the Act to warrant any such definition of preference.

Section 60 A contains a definition of "preference".

Carson, Pirie & Scott v. *Chicago Title & Trust Co.*, 182 U. S. 438.

That definition contemplates a test of equality to be made at the time of bankruptcy and at no other time. The definition of "preference" contained in Section 60 A must be read with Section 60 B, wherever the word "preference" occurs.

Sections 60 A and 60 B must be read together, and they must be so read in the light of the all-prevailing purpose of the Bankruptcy Act.

One of the main purposes of the Bankruptcy Act is to provide for equal division of the assets among the creditors. An actual division is, of course intended—not some imaginary or theoretical distribution. Equality is to be made real as far as possible.

In order to insure real equality in distribution as of the date of bankruptcy, a marginal period of four months has been arbitrarily fixed by the courts so that equality may not be disturbed by the grasping demands of the vigilant during that penumbral period.

Always, however, the goal is equality of distribution in bankruptcy and the four months' truce must be interpreted and construed with that goal in mind.

The word "then" in the phrase "and the transfer then operate as a preference" has misled and confused some of the courts. They have said that the payment must operate as a preference at the time of its receipt or not at all. So far, we are in accord. They have ruled, however, that this construction compels a computation of assets at the time of payment, mathematically divided by the liabilities, and that the resultant fraction is the

only guide by which the preferential character of the payment can "then" be judged.

They have failed to see that any part payment, which leaves the creditor with the balance of his claim unpaid, necessarily operates, "then", at the time of payment, as a preference, irrespective of the fraction which other creditors might then have received.

When a creditor receives a part payment from an insolvent concern during that four months' period, such payment necessarily endangers the equality of distribution. The creditor receives his payment on account and still remains creditor for the balance of his claim, on which he will receive the same dividend as all other creditors of the same class. Thus, for a portion of his claim, he is paid 100% and for the balance of the claim he receives the bankruptcy dividend. Necessarily, such part payment operates as a preference in that it enables him to receive more than his share.

There may be circumstances under which the payment does not necessarily operate as a preference, for example, when the payment is accepted in full accord and satisfaction and the creditor is left with no balance of the claim to be proved in the bankrupt estate.

Irving Trust Co. v. *Townsend,* 65 Fed. (2nd) 406.

Or when at the time of the part payment, all other creditors have actually received a similar payment.

Templeton v. *Wollens,* 200 Fed. 257.

In that case, although the creditors did not actually receive the contemplated payment, it was in good faith intended that they should, and the preference was held to be non-voidable because the creditor had no reason to believe that a preference was intended. In other

words, if the payments had been made to all, there would have been no preference.

The subject has received intensive examination by District Judge Patterson of the Southern District of New York in the case of *Jentzer* v. *The Viscose Company* (not reported). Not as authority but as the well-considered opinion of a jurist, a copy of his opinion is appended to this brief. The pertinent portion is found on pages 25 to 28.

An appeal was taken from his decision to the Circuit Court of Appeals in the Second Circuit and argument in that court has been postponed, awaiting decision of our case. After discussing all of the authorities, he concludes as follows:

> "I am therefore convinced that where a creditor takes a transfer in partial payment of his claim from the bankrupt while insolvent and within four months of bankruptcy, proportionate payments not being made to all other creditors of the same class, the transaction 'then operates as a preference' within the meaning of section 60 (b), and it is not saved by the fact that the bankrupt at the time retained assets sufficient, if then distributed among his other creditors, to yield as great or a greater percentage to them."

The weight of authority supports this view.

Commerce Guardian Bank v. *Devlin*, 6 Fed. (2nd) 518, C. C. A. 6th;
Matter of Star Spring Bed Co., 265 Fed. 133, C. C. A. 3rd;
Eyges v. *Boylston National Bank*, 294 Fed. 286;
Rubenstein v. *Lottow*, 223 Mass. 227.

In that case, the Supreme Court of Massachusetts, through Chief Justice RUGG, reasoned the matter as follows:

"The question of law which arises in the light of these facts is whether in bankruptcy the preferential character of a transfer of property is to be determined as of the date of the transfer, July 30, 1912, or of the filing of the petition in bankruptcy, October 3, 1912.

We are of the opinion that the judge ruled rightly that the decisive date was that of filing the petition.

As a matter of verbal construction, the governing section of the Bankruptcy Act leads to this conclusion. The pertinent words of the Bankruptcy Act are as in the footnote 1. They express futurity. Whether 'the effect of the enforcement' of the transfer 'will be to enable' one creditor to get a larger percentage of his debt than other like creditors by implication reaches forward to a time when an authoritative distribution can be made. Not until then can the respective percentages be determined with conclusiveness. If the time of the transfer had been the crucial time, the word 'enables' naturally would have been used instead of the words 'will be to enable' found in the Act. The words 'effect of the enforcement of such * * * transfer' also import adjudicated bankruptcy rather than the time of transfer. There can be no occasion for an 'enforcement of * * * such transfer' until a petition in bankruptcy. A transfer of property by a debtor to his creditor apart from statute, takes effect and is enforced automatically at once. There is no fraud at common law about such transfer not exceeding in value the amount of the debt, even though a preference of one creditor over another is thereby produced. Lyon v. Wallace, 221 Mass. 351, 35 Am. B. R. 688, 108 N. E. 1075. It needs no procedure to enforce it, but becomes enforced by the mere transfer. A question touching its enforcement does not arise until adjudicated bankruptcy intervenes. 'The effect' of the enforcement cannot be settled until then. It seems indubitably to follow that its effect must be decided upon conditions as they then exist. The words 'creditors of the same class' betoken adjudicated bankruptcy as the time for the application of the test. These words have no meaning except in

connection with administration in bankruptcy. There are no clases of creditors at common law outside the Bankruptcy Act.

The bankruptcy court necessarily decides what the percentage then due to other creditors of all classes will be. That is one of the essential steps in its procedure. It would seem a strange anomaly to compel that court to try out and decide another question of percentages relating to another time. If the defendant's contention is sound, the bankruptcy court well might be required, in the case of successive preferences, to enter into prolonged investigations as to the precise ratio to each other of the bankrupt's debts and liabilities at numerous different dates within the four months' period preceding the filing of the petition. Such judicial investigations inevitably would cause expense to the public and to the trustee representing the other creditors, and could confer no advantage on the debtor. They could benefit no one except a creditor who had accepted a preference, having reasonable cause to believe that he thereby was securing a preference from a bankrupt debtor. It cannot be presumed that such extreme solicitude at such cost would be manifested by the law for such a creditor, in the absence of words expressing an unmistakable purpose to that end. The words of the Act disclose no such design. On the contrary, they tend in the opposite direction.

The interpretation urged would result in inequality of distribution of the debtor's assets among his creditors. Equality of distribution is one of the fundamental objects of a bankruptcy law. The indebtedness of a business man often gradually progresses from a nascent state of insolvency to the point where a petition in bankruptcy is filed. Beginning with a bare excess of debts over assets, he may go through the gamut to a very large and disproportionate excess in this respect. Preferences during such a period of declining ratio of assets to debts, adjusted according to the theory of the law now put forward, would result in a sliding scale of inequality between the various preferred creditors, as well as inequality between all creditors who have obtained preferences

and the general creditors who depend upon the equality of the law to protect their interests against the alertness of creditors seeking unequal advantages through their own keenness in scenting approaching bankruptcy."

The decisions holding to the contrary are mainly:

Mansfield Lumber Co. v. *Sternberg,* 38 Fed. (2nd) 614, C. C. A. 8th;
Peck & Co. v. *Whitmer,* 231 Fed. 893, C. C. A. 8th;
Haas v. *Sachs,* 68 Fed. (2nd) 623.

In those cases and others supporting the same view, all the emphasis has been placed upon the words "then operating as a preference" in section 60 (b), and no stress has been laid upon the definition of a preference found in section 60 (a). The former section undoubtedly contemplates the actual division of the assets among the creditors at the time of bankruptcy and sets up a standard by which the preferential character of the payment made within four months prior thereto shall be judged by its effect in such actual distribution.

Such a test appeals to our sense of reality and is comparatively easy to apply and is consonant with the main purpose of the Bankruptcy Law. The adverse authorities overlook the effect of the actual distribution of the assets and substitute therefor some imaginary distribution which might take place if at the time of the disputed payment, the entire assets of the bankrupt were distributed among all of its creditors. Such a construction sets up a standard which is based on fiction, a test which would be difficult, if not impossible, to apply and which would run directly counter to the main purpose of the Bankruptcy Law.

The effect of the contrary rule, contended for by the appellant, is best illustrated by the facts in this case.

The sum of $1,000 was not paid in one payment and, if our opponent is correct, each partial payment must be judged by itself. Consequently, when this creditor received the first payment of $250, he took a small portion of his claim—much less than other creditors might have received if there had been an actual distribution at that time—and therefore according to the argument, he received no preference. The same conclusion holds good for the second payment, and the third and fourth and the fifth. If our opponent's reasoning be sound, this creditor might have continued to receive other payments with impunity and as no one of these payments could have given him a greater share than other creditors (if distribution had then been made) he may retain each and every one of them, and a student of mathematics would tell us that he could finally receive some amount approaching, but never quite equalling, 100% of his claim. All this could happen within four months of the bankruptcy and while the concern was insolvent and while the creditor had reasonable cause to believe that a preference was intended. Nevertheless, although he might thus receive almost 100% of his claim and other creditors receive nothing or next to nothing, there would be no voidable preference and he would be permitted to retain every penny he had thus received. Such a conclusion could not have been intended by the framers of the Bankruptcy Act.

But we are told that our interpretation of the Act requires the condemnation of every partial payment received by a creditor within four months of bankruptcy while the debtor is insolvent and that such a construction would render ordinary business impossible.

Ordinary business will not be disturbed. The question of voidable preference does not arise unless bankruptcy occurs within the period and unless the concern is insolvent at the time of the payment and unless

the creditor had a reasonable cause to believe that a preference was intended. We are speaking only of a bankrupt business which has been insolvent for at least four months prior to its bankruptcy. In that business, we are concerned only with those creditors who received money under circumstances which put them on guard as to the insolvent condition and as to the intent of the debtor. We can eliminate from consideration all payments made in the usual course of trade and, in so doing, we would interfere only with those tainted transactions which, on the eve of bankruptcy, threaten to disturb the equality of distribution.

Any construction of the statute which would require the trustee, in order to avoid a preference, to prove not only insolvency at the time of the payment, but also the exact degree of insolvency, would place upon the trustee an insuperable burden and would in effect nullify the purpose of the law.

In our construction, the trustee must prove insolvency at the time of payment, but it is sufficient for our purposes that the liabilities exceed the assets. It is not necessary that we prove with exactitude the discrepancy between the assets and liabilities, so long as it is clear that the latter exceed the former. Under the contrary construction, the trustee would have to prove with precision the value of every asset and the extent of every liability on or about the day when the payment was made. He would have to prove these facts with regard to every such payment. Bearing in mind that we are dealing with a going concern whose assets and liabilities must fluctuate from day to day and from hour to hour, we can see how extremely difficult, if not impossible, it would be for the trustee, after the event, to prove on a day certain the exact value of assets and liabilities. Approximations would not serve the purpose inasmuch as we must prove not only insolvency, but its exact degree. If such a bur-

den of proof were placed on the trustee, in most cases he would be utterly unable to carry it and the "vigilant" creditor would again come into his own as in the days before the present Bankruptcy Act. One of the main purposes of the Act, the equal distribution of assets among creditors, would be frustrated.

Conclusion.

The creditor, by filing its claim in bankruptcy, invited a ruling as to its validity and submitted itself to the jurisdiction of the Bankruptcy Court for the purpose of such ruling. When the trustee asks that the payments be adjudged preferential and proceeds with the proof of its case, it is too late for the creditor to withdraw.

The preferential character of the payments must be judged by their effects on the actual distribution of the assets in bankruptcy. Any other construction of the law would nullify its main purpose, namely, the equality of distribution among creditors.

The decree of the court below should be affirmed.

Respectfully submitted,

CHARLES A. HOUSTON,
Counsel for Respondent.

AARON ROSEN,
ARNOLD A. JAFFE,
of Counsel.

Opinion.

No. 539

UNITED STATES DISTRICT COURT,

SOUTHERN DISTRICT OF NEW YORK.

HARRY J. JENTZER, Trustee in Bankruptcy of Yarns Corporation of America, Complainant, *against* THE VISCOSE COMPANY and CHARLES H. LE ROY, Respondents.	In Equity 73-157.

MAXWELL S. MATTUCK, for plaintiff.

SPENCER, ORDWAY & WIERUM (John A. McManus, Samuel H. Ordway, Jr., and Roderick B. Travis, of Counsel), for defendants.

PATTERSON, D. J.:

The suit is to set aside a transfer of property by the bankrupt to the defendant LeRoy, the latter acting in behalf of the defendant Viscose Company, on the ground that the transfer was a voidable preference. While the form of the suit is the familiar one, the facts that gave rise to it are unusual. For convenience the Viscose Company will be referred to as the defendant.

An involuntary petition in bankruptcy was filed against Yarns Corporation of America on September 30, 1931. The transfer complained of took place on June 3, 1931, which is within the time limitation of four months.

The bankrupt was in the yarns business. Its affairs were managed by one Grisman. It had plants in Brooklyn, Allentown, Pa., and Spartanburg, S. C. Some years before it had issued bonds secured by a mortgage on the Spartanburg property and on certain other assets. $244,000 of these bonds were outstanding in 1931. The bankrupt had also become indebted to the defendant in the amount of $500,000 for merchandise purchased. In May, 1930 this liability had been scaled down to $319,000 by a written agreement, the validity of which is assumed by both parties and will not now be re-examined. The defendant refused thereafter to extend any further credit, however, and the bankrupt was hard put to buy its supply of yarn. Until the transfer in question it made no payments in reduction of the $319,000 debt. By the beginning of 1931, the Brooklyn and Spartanburg plants had closed down altogether and the Allentown plant was limping along on a small volume of business. The company was plainly doomed unless there was a radical change for the better.

Early in 1931 one Law of Spartanburg, whose firm had bought and distributed the bond issue and who had been made a director of the bankrupt to represent the bondholders, came to New York and had a series of conferences with Caulfield, credit manager of the defendant. The bankrupt's inability to pay the $319,000 debt was discussed. Law put it to Caulfield that if the amount of the defendant's claim were reduced the claim might be paid and the bankrupt thereby given a new lease on life. These conferences eventuated in a promise by the defendant, evidenced by letter of February 20, 1931, to accept $75,000 in full settlement of the $319,000 debt, provided payment should be made by May 20, 1931, the $75,000 to be raised by the bankrupt either through new funds or through liquidation of assets under Law's direction. Law then turned his attention toward raising new money, but

the bank to which he took the matter found conditions in the company thoroughly unsatisfactory and declined to proceed. On May 8th Law called on Caulfield to report that the $75,000 could not be raised. He said that on examination the bankrupt's accounts receivable had proved to be of low grade, that the business could not be operated successfully. His proposal was that a creditors' committee be formed to wind up the company. Caulfield opposed the suggestion, saying that he favored bankruptcy and might submit a plan later. This marked the end of Law's efforts.

A week or so later Grisman, the bankrupt's president, took up with Caulfield the possibility of clearing off the defendant's claim. He proposed that the bankrupt should assign certain slow assets to a trustee and that on realization of $75,000 for the defendant the $319,000 claim should be deemed discharged. Caulfield accepted the proposal, subject to approval of his superiors. Accordingly an instrument dated June 3, 1931 was executed. It is the transfer made pursuant to this instrument that is assailed as a voidable preference. The instrument provided that the bankrupt would pay $75,000 to the defendant, and that the defendant would accept that sum in full settlement of all claims. As part of the same transaction the bankrupt transferred to LeRoy, acting as trustee, merchandise, accounts receivable and claims as collateral security for its promise to pay the $75,000. LeRoy was to reduce the assets to cash, from the proceeds to pay $75,000 to the defendant, and to return any remaining assets to the bankrupt. In the event that less than $75,000 should be realized, the defendant was to take whatever was realized as payment on account of its $319,000 claim. The assets so assigned to LeRoy in trust for the defendant had a large book value, but on actual realization by LeRoy some months later they brought in only $15,000, and yielded to the defendant a net of

only $13,000. Their fair value on June 3, 1931 was not substantially in excess of $15,000, the sum that LeRoy was able to squeeze out of them. In effect, therefore, the transfer was of assets worth $15,000 as a payment in reduction of the defendant's claim for $319,000.

This transfer left the bankrupt with the real estate and machinery covered by the mortgage to secure the $244,000 bonds, and with about $24,000 in other assets. The greater part of these other assets was in a wholly-owned subsidiary. The bankrupt's business, which had been moribund already for some months, ceased completely. There was a certain amount of activity on the part of the subsidiary, but even here all signs of life ceased shortly before bankruptcy. Prior to bankruptcy the unencumbered assets had been consumed through salaries and other expenses. The trustee in bankruptcy could find assets of only $100.

The bondholders brought suit for foreclosure of the mortgaged property in September, 1931. They eventually realized out of the security some $62,000, a figure which in my opinion also reflects the fair value of the property in June, 1931. This left an unsecured deficit of $182,000, upon which the bankrupt was generally liable and for which the bondholders filed claims in the bankruptcy proceeding.

The bankrupt was hopelessly insolvent when it made the transfer under attack. The defendant makes no more than a faint suggestion to the contrary. The assets, including those mortgaged, were $101,000, against liabilities of $574,000. The liabilities were made up of $319,000 owed to the defendant, $244,000 owed to the bondholders, and $11,000 owed to various others. If the mortgaged properties at $62,000 and an equivalent amount of bonds are omitted, the bankrupt had before the transfer assets of $39,000 and unsecured liabilities of $512,000.

The defendant's position is that the transaction gave it no greater percentage of its claim than was available

to other creditors of the same class, and also that it had no reasonable cause to believe that a preference would be effected. It is pointed out that the transfer covered property worth only $15,000, that this was a payment of only 4.7 per cent on the defendant's claim of $319,000, and that after the transfer the defendant still had unencumbered assets of $24,000, an amount which, if then distributed *pro rata* among creditors other than the defendant, would have given them a payment of 12 per cent. The fact that the other creditors actually received nothing and will get nothing out of the bankrupt estate if the transfer is sustained is said to be immaterial in law.

1. On the point of "greater percentage", the first consideration is the Bankruptcy Act itself. Section 60 (a) defines a preference as the suffering of a judgment or the making of a transfer by the bankrupt while insolvent and within four months of bankruptcy, where

> "the effect of the enforcement will be to enable any one of his creditors to obtain a greater percentage of his debt than any other of such creditors of the same class obtain."

Section 60 (b) states the conditions under which a preference shall be voidable. Not all preferences are voidable by the trustee. Section 60 (b) provides that a judgment or transfer shall be voidable where made within the four months' period

> "If, at the time of the transfer, * * * the bankrupt be insolvent and the judgment or transfer then operate as a preference, and the person receiving it * * * shall then have reasonable cause to believe that the enforcement of such judgment or transfer would effect a preference."

The Supreme Court of Massachusetts has held that the preferential aspect of a transfer attacked as voidable,

in so far as its effect in giving a greater percentage is concerned, should be judged solely by the situation existing later on at the time of bankruptcy. This construction is the result of placing emphasis on Section 60 (a), with its words of futurity, and of passing by the requirement in Section 60 (b) that the transfer "then" (obviously referring back to the clause "at the time of the transfer") operate as a preference. *Rubinstein* v. *Lottow,* 223 Mass. 227. The District Court of Massachusetts has taken the same view, making the test of "greater percentage" turn not on the ability of the bankrupt at the time of the transfer to pay a like or greater percentage to other creditors, but on whether the others actually will receive as great a percentage out of the bankrupt estate. *Eyges* v. *Boylston Nat. Bank,* 294 Fed. 286.

In other courts the view has been taken that the preferential effect of a transfer must be judged according to its operation at the time the transfer was made and not according to later results. Prominence is given to the clause in Section 60 (b) that the transfer must "then", that is, at the time of the transfer, operate as a preference. From this premise of statutory construction, the conclusion seems to have been drawn that if a transfer leaves the bankrupt with enough to pay a like or greater percentage to other creditors of the same class, there cannot be a preference. The fact that the remaining assets never reach other creditors is disregarded. A line of cases in the Eighth Circuit supports this view. *Peck & Co.* v. *Whitmer,* 231 Fed. 893; *Mansfield Lumber Co.* v. *Sternberg,* 38 Fed. 2nd, 614; *Haas* v. *Sachs,* 68 Fed. 2nd, 623. The state courts in Vermont and Kansas are in accord. *Slayton* v. *Drown,* 93 Vt. 290; *Brittain Drygoods Co.* v. *Bertenshaw,* 68 Kans. 734. See also *Jackson* v. *Steele Mfg. Co.,* 37 S. W. 2nd, 762 (Tex. Civ. App.); *Remington on Bankruptcy,* Sec. 1812. In the *Haas* case, *supra,* it was said:

> "This court has held that whether the effect of the transfer will be to enable the creditor receiving it to obtain a greater percentage of his claim than other creditors of the same class, is to be determined as of the date of the actual transfer, and not as of some future date when later events have altered the assets or liabilities, or when court liquidation may have caused shrinkage of values and other losses" (68 Fed. 2nd, at p. 625).

As matter of statutory construction, it is difficult to see how fair effect can be given to the explicit provisions of Section 60 (b) by the adoption of a standard less favorable to the creditor receiving the transfer. If there is a conflict between Section 60 (a) and Section 60 (b), the latter must be accorded at least equal weight. It is the only provision of the Act that deals directly with voidable preferences. The conclusion must be that under the Bankruptcy Act the preferential effect of a transfer, so far as its voidability is concerned, is to be determined not only by its ultimate result (Section 60 [a]), but also by its immediate result as of the time of the transfer (Section 60 [b]). If it is not more advantageous to the receiving creditor at the time of the transfer than to others of his class, it is not a voidable preference.

But it does not follow from this that a transfer to a creditor of no more than his proportionate share of the debtor's assets cannot be a voidable preference. Where the transfer is merely a payment on account of the claim, the receiving creditor still has the balance of his claim, and as to this unpaid balance he stands on a parity with other creditors who got nothing at the time. It is not accurate therefore to say that he leaves enough for other creditors to give them equal or greater percentages. What he leaves is for himself on the unpaid balance of his own claim, as well as for other creditors. Here the bankrupt owed the defendant $319,000 and other creditors $193,000. It transferred to the defendant property worth $15,000

as a payment on account, reducing the amount of the defendant's claim to $304,000. It still had assets worth $24,000. The defendant did not leave these assets for distribution among other creditors. As to those remaining assets the defendant had rights, to the extent of its unpaid balance of $304,000, as perfect as the rights of other creditors. It could take further payments, pursue creditors' remedies or share in involuntary liquidation. All that happened was that as to $15,000 of its claim the defendant was paid in full, and it still had the balance of its claim for future collection out of the bankrupt's assets. The effect, immediate as well as ultimate, was that the defendant obtained a greater percentage on its claim than other creditors of the same class; it obtained, in other words, a preferential payment.

There is support for this view. In *Commerce-Guardian Bank* v. *Devlin*, 6 Fed. 2nd, 518 (C. C. A. 6), the court declared a payment similar to that in the present case to be a voidable preference. Judge Knappen said (p. 519):

> "We see no merit in the suggestion that the bank got no greater percentage on its own claim (about 48 per cent) than creditors generally would have had, if we accept the estimate of 50 per cent made by the bankrupt's bookkeeper. The bank actually received 100 per cent on $6,300 of its claim, and, if the preferences were upheld would be entitled to receive upon the balance of its claim the same percentage as other creditors of the same class."

A like situation was presented in two of the cases in the Eighth Circuit already cited, *Peck & Co.* v. *Whitmer* and *Haas* v. *Sachs*, and also in the Vermont and Kansas cases adverted to, but in these instances the transactions were treated as non-preferential. In those cases sight seems to have been lost of the fact that the creditor who received the payment on account of his claim retained the balance of his claim for further collection on a parity

with other creditors. The case was considered as if the creditor had dedicated the remaining assets to the other creditors, which was not the fact. The receiving creditor got more than other creditors and it was obvious all along that he would get more if the transfer should be sustained.

Mansfield Lumber Co. v. *Sternberg, supra,* also in the Eighth Circuit, is not subject to this criticism. There the defendant, with a claim of $21,000, took a transfer of property, not as partial payment but in full satisfaction of the claim. The property was worth only $1,600. The defendant thus received only seven per cent of its claim, and its claim was extinguished. The bankrupt retained property sufficient to pay a dividend of eleven per cent to other creditors. The trustee's attack on the transaction as a preference was unsuccessful. It seems manifest that the transaction did not enable the defendant to get a larger proportion of the bankrupt's property than was left for other creditors. The situation was not like a payment merely on account of a claim. Cases somewhat analogous are *Irving Trust Co.* v. *Townsend,* 65 Fed. 2nd, 406, 408 (C. C. A. 2), and *Mart* v. *Emmerson-Brantingham Co.,* 203 Fed. 60 (D. C. Mo.).

I am therefore convinced that where a creditor takes a transfer in partial payment of his claim from the bankrupt while insolvent and within four months of bankruptcy, proportionate payments not being made to all other creditors of the same class, the transaction "then operates as a preference" within the meaning of Section 60 (b), and it is not saved by the fact that the bankrupt at the time retained assets sufficient, if then distributed among his other creditors, to yield as great or a greater percentage to them.

2. Did the defendant have reasonable cause to believe, at the time of the transfer, that the transfer would effect a preference in its favor? Plainly it was aware of the

insolvency of the Yarns Corporation. A creditor of a solvent debtor does not agree to take $75,000 in full satisfaction of an undisputed claim for over four times that amount. In a case where the transfer is only a partial payment, as in this case, it is necessary to show also that the defendant had reasonable cause to believe that it was obtaining a greater percentage of its claim than other creditors. See *Irving Trust Co.* v. *Townsend, supra.* The evidence discloses that the defendant had such reasonable cause. It knew that it was getting part of its own claim paid in full and that the other creditors were then getting nothing. This is not a case where the defendant had reason to believe that the bankrupt was planning to make proportionate payments to all creditors. In such cases reasonable cause to believe that a preference would be effected is lacking. *Smith* v. *Hewlett Robin Co.,* 178 Fed. 271 (C. C. A. 2); *Templeton* v. *Wollens,* 200 Fed. 257 (C. C. A. 2); *In re Varley & Bauman Clothing Co.,* 191 Fed. 459 (D. C. Ala.).

It is true that the defendant was assured by Grisman at the time that the bankrupt had "no creditors of any account other than yourself", and that "the rights of others are not affected". But the defendant already had notice to the contrary. It had known for months that the bankrupt had a large issue of bonds outstanding, and from the correspondence and conferences with Law and Blackford it knew that the firm which had distributed and sponsored the bonds was worried as to the adequacy of the security. Inquiry would have disclosed that the security behind the bonds was altogether inadequate, and the defendant was acquainted with enough facts to put in on inquiry. *Wright* v. *William Skinner Mfg. Co.,* 162 Fed. 315 (C. C. A. 2); *Pender* v. *Chatham Phenix Nat. Bank & Trust Co.,* 58 Fed. 2nd, 968 (C. C. A. 2).

3. The defendant and the bondholders were creditors "of the same class", within the meaning of Section 60

(a). The classes referred to in that section are the four classes of creditors whose priorities in distribution are specified in Section 64—creditors with claims for taxes, creditors with claims for wages, creditors with statutory priorities, and all other creditors. The fact that some creditors are partially secured does not put them in a different class from wholly unsecured creditors. *Swarts* v. *St. Louis Fourth Nat. Bank,* 117 Fed. 1 (C. C. A. 8); *In re Star Spring Bed Co.,* 257 Fed. 176 (D. C. N. J.), affirmed in 265 Fed. 133.

The plaintiff is entitled to a decree adjudging the transfer a voidable preference. Against the defendant Viscose Company there will be a decree for the payment to the plaintiff of all moneys received or applied to the use of that defendant. Against the defendant LeRoy the plaintiff may have an accounting and a direction for transfer of any property not yet turned over by him to the Viscose Company. LeRoy was acting as agent or trustee for the Viscose Company and is under no personal liability for money or property already turned over by him to the party for whom he was acting. *Carson* v. *Federal Reserve Bank,* 254 N. Y. 218. The cause of action charging a transfer in fraud of creditors will be dismissed. The decree will be settled on five days' notice.

(Sgd.) ROBERT W. PATTERSON,
United States District Judge.

November 17, 1934.